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IN THE

Supreme Court of the United States

OCTOBER TERM 1971

Docket No. 71-1197

O'NEILL RYAN and UNITED STATES TRUST COMPANY OF NEW YORK, as Trustee of a Trust dated April 15, 1968 for the benefit of Sara Ryan Hill,

Petitioners,

against

J. WALTER THOMPSON COMPANY,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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March 17, 1972

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

Petitioners, O'Neill Ryan and the United States Trust Company of New York (hereinafter "Ryan"), seek a writ of certiorari to review the judgment of the United States Court of Appeals for the Second Circuit, affirming a final judgment of the United States District Court for the Southern District of New York. Petitioners seek the aid of this Court to correct a material misinterpretation of the common law of New York and to clarify the disclosure requirements mandated by Section 10(b) of the Securities Exchange Act of 1934 [15 U.S.C. § 78j]; and the SEC Rule 10b-5 [17 C.F.R. 240.10b5].

In determining the validity of a close corporation's option to repurchase its stock under the law of New York, the Second Circuit has sanctioned a violation of the time-honored rule that there be no unreasonable restraint on the free alienation of property. Specifically, that Court has ruled that a corporation's first option to repurchase its stock, which option effectively restricts transfer of those securities, is reasonable in and of itself, regardless of whether or not the corporate purpose originally underlying the opinion no longer exists.

In so ruling, the Second Circuit failed to consider the impact of a close corporation's decision to "go public" upon the validity of an option which was originally intended to maintain a close corporate identity. Moreover, the Court's per se analysis is in conflict with the established law of New York, which requires the Court to consider all of the facts and circumstances surrounding the exercise of an option in order to determine its reasonableness as a restriction on transfer.

Additionally, the Second Circuit determined that a close corporation need not disclose to a selling shareholder its decision to "go public" and the resulting invalidity of its option. In reaching its determination, the Second Circuit totally disregarded the disclosure requirements mandated by the federal securities laws. The failure to apply these statutory provisions in this case paves the way for continued substantial abuse of first option provisions in connection with every public offering involving a corporation which was previously closely held.

Opinions Below

The opinion of the Second Circuit is appended hereto as Appendix "A"; the opinion of the District Court is reported at 322 F. Supp. 307 (S.D.N.Y. 1971).

Jurisdiction

The Second Circuit's order affirming the final judgment of the District Court (which had granted summary judgment to respondent) was entered on November 18, 1971. A petition for rehearing *en banc* was denied by order of the Second Circuit on December 20, 1971. Accordingly, this petition is timely filed. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1). The original judisdiction of the District Court was invoked under § 27 of the Securities Exchange Act of 1934 [15 U.S.C. § 78aa] and the doctrine of pendent jurisdiction.

Questions Presented

1. Is a close corporation's first option to repurchase its stock valid per se, or may a change in circumstances and conditions subsequently render the repurchase option invalid as an unreasonable restraint upon alienation?

2. May a close corporation which has decided to "go public" and to remove transfer restrictions on its stock, thereafter continue to exercise options to repurchase its stock at prices far below the true value thereof, pursuant to an option agreement, the validity of which agreement depended upon the continued existence of the corporation's close identity?

3. Does a close corporation's failure to advise a selling shareholder of (1) its decision to "go public", (2) the resulting invalidity of its repurchase option, and (3) the anticipated substantial appreciation in the value of shares repurchased, constitute a violation of the anti-fraud provisions of the federal securities laws?

Statement of the Case

In this action, Ryan seeks to rescind sales of J. Walter Thompson Company ("Thompson") stock made by him to Thompson in January 1969, pursuant to Thompson's exercise of certain repurchase options. The gravamen of Ryan's complaint is that at the time these options were exercised, Thompson had decided and in fact taken steps to "go public" and that as a result thereof the options were unenforceable, since they were no longer supported by a valid corporate purpose and therefore constituted an unreasonable restraint upon alienation under the law of New York. Additionally, Ryan claims that Thompson's failure to disclose the contemplated public offering, the resulting invalidity of its option and the anticipated appreciation in the value of stock held by Ryan, prior to the time it repurchased Ryan's stock, constituted a violation of the anti-fraud provisions of the federal securities laws.

The Litigation

The litigation was commenced by the filing of a summons and complaint on May 26, 1969. Thompson's answer denied the material allegations of Ryan's complaint and asserted a counterclaim seeking to recover the amount that Thompson had paid Ryan upon the purchase of his stock in January 1969, plus dividends.

Following completion of discovery proceedings, both parties moved for summary judgment, each alleging that there was no genuine issue as to any material fact and that summary judgment was appropriate. Ryan argued before the District Court that under the law of New York, the restraint upon alienation imposed by Thompson's option on his stock must be "reasonable" under all circumstances in order to be valid, and that the Court must look to the

purpose supporting the restraint in order to determine its reasonableness.

By order entered on January 29, 1971, the District Court granted Thompson's motion, holding that it was entitled to judgment "as a matter of law." By this same order, Ryan's motion for summary judgment was denied and Thompson's counterclaim was dismissed. The District Court rejected Ryan's contention, holding that under New York law a first option provision is "in and of itself . . . reasonable" [322 F. Supp. at 313] and that no other purpose or object is necessary to justify its validity. The District Court further ruled that since Ryan was under a compulsion to sell his securities to Thompson, there could be no violation of federal securities laws.

The Facts

During the course of his employment with Thompson, Ryan purchased shares of Thompson's common and preferred stock. All of the stock purchased was subject to certain transfer restrictions and repurchase options which effectively restrained free alienability. The avowed purpose of the restrictions, which are set forth in Thompson's Certificate of Incorporation, was to enable Thompson to remain as a close corporation.

On January 31, 1966, Ryan retired from the active employ of Thompson, having achieved the position of Vice President and Director. Pursuant to the terms of its Certificate, Thompson reserved an option to call Ryan's stock. This option arose on the first day of January in the third calendar year following retirement and remained effective for 90 days. In the event this option expired and Ryan received a subsequent offer to purchase his stock, Thompson reserved an additional option to repurchase the stock, either at the price stated in the offer to Ryan or at the "call price"*, whichever was lower.

* The "call price" was based upon the net asset value of the corporation, specifically excluding good will.

On January 14, 1969, Thompson exercised its option and purchased Ryan's stock at the "call price", paying Ryan $276,200. Significantly, prior to the repurchase of this stock and at least as early as November 1968, the Thompson management had made a decision to "go public". In point of fact, as early as August 1968, Thompson, in need of working capital, had planned and taken steps toward a public offering. Thus, in August 1968 Thompson met with Morgan, Stanley & Co., its investment banker, to discuss the possibility of that firm's managing the underwriting of Thompson's public offering. On October 4, 1968, Morgan Stanley recommended that Thompson commence preparation for a public offering.

On November 13, 1968, Breed, Abbott & Morgan, Thompson's counsel, advised Thompson that it could legally exercise those options becoming due in January 1969. The opinion was sought by Thompson in light of the fact that it expected to "go public" during the course of 1969. On November 15, 1968, Breed, Abbott & Morgan commenced work on a prospectus for Thompson in connection with the public offering, the first draft of which was completed on November 27, 1968. Throughout January and February 1969, Thompson had discussions with its major clients concerning the possibility of filing its registration statement with the SEC in March 1969.

On March 28, 1969, Thompson filed its printed Form S-1 Registration Statement with the Securities and Exchange Commission in Washington, D.C. Finally, on June 4, 1969, Thompson made a public offering of 790,000 shares of its common stock. As of the date of the offering, the stock which Ryan sold to Thompson under option compulsion in January 1969 for $276,200 had a value of $1,026,000 as a result of Thompson's recapitalization and the addition of "good will" to the value of the stock. At no time prior to the exercise of the option in question did Thompson disclose to Ryan its decision to "go public" and the impact of that decision upon the validity of the Thompson option.

The Second Circuit's Opinion

In affirming the judgment of the District Court dismissing Ryan's action, the Second Circuit upheld the lower court's per se analysis and ruled that the Thompson option did not constitute an unreasonable restraint upon alienation. In so ruling, the Second Circuit failed to consider the impact of Thompson's decision to "go public" upon the validity of the option; instead, it chose to limit the scope of its inquiry to the four corners of the option agreement. Thus, in determining that Thompson's option did not constitute an unreasonable restraint upon alienation, the Court held that a first option to a close corporation is valid irrespective of whether or not the corporate purpose underlying the option agreement no longer existed. In reaching its decision, the Circuit Court failed to inquire into the purposes underlying the restraint and the facts and circumstances existing at the time the option was exercised. The Circuit Court's failure to make such an inquiry not only produced an unjustified and unintended result, but more importantly, sanctioned a violation of the time-honored rule of New York law that there be no unreasonable restraint upon alienation.

The Circuit Court further ruled that "since Ryan was obligated to sell his shares to JWT in January 1969, whatever he knew or did not know regarding JWT's plans to go public was irrelevant". The Court's holding is predicated solely upon, and assumes the existence of, a valid and binding option agreement.

Reasons for Granting the Writ

As a consequence of its departure from the settled law of New York, and by reason of the broad impact and far-reaching effect the decision of the Second Circuit will have in the field of corporate and securities laws, the issues in

this litgation involve questions of exceptional national importance which should be reviewed by this Court.

1. *The Second Circuit has decided an important question of law in a way that is irreconcilably in conflict with the applicable state law.*

Ryan argued before the Second Circuit that under the law of New York the restraint upon alienation imposed by Thompson's option must be "reasonable" in order to be valid, and that the Court must look to the purposes supporting the restraint in order to determine its reasonableness. That Court flatly rejected Ryan's contention, holding that an option would be invalid only if it "prevented transfer of the stock as opposed to merely delaying transfer, as here, by giving the corporation the right of first refusal." This rigorous application of a per se rule with respect to the validity of the Thompson option is erroneous and irreconcilably in conflict with the law of New York.

Under the law of New York, shares of corporate stock are regarded as personal property subject to the "time-honored" rule that there be no unreasonable restraint upon their alienation. [*Allen* v. *Biltmore Tissue Corp.*, 2 N.Y. 2d 534 (1957).] The New York Court of Appeals has expanded on this "property concept" in *Biltmore*, by stating that the courts of New York, "as Section 176 of the Personal Property Law implies", will sustain a restriction imposed on the transfer of stock only if it is "reasonable" [*Id.* at 541].

Similarly, in *Penthouse Properties, Inc.* v. *1158 Fifth Avenue, Inc.* [256 App. Div. 685 (1st Dept. 1939)], the court declared "the general rule that ownership of property cannot exist in one person and the right of alienation in another . . . has in this State been frequently applied to shares of corporate stock . . . and cognizance has been taken of the principle that 'the right of transfer is a right of

property, and if another has the arbitrary power to forbid a transfer of property by the owner that amounts to annihilation of property' " [*Id.* at 690-91].

In discussing the scope of the judicial inquiry necessary to determine the validity of a particular restraint, the court stated:

> "[I]f [a] restraint on alienation of the stock may be said to be imposed at all, it is a restraint which in every respect is reasonable and appropriate to the lawful purposes to be attained." [*Id.* at 692]

Thus, it is clear that under the law of New York the "reasonableness" and validity of the option herein rests squarely upon the surrounding facts and circumstances; more particularly, upon a determination of whether or not any lawful purpose supported the option at the time of its exercise. Contrary to the Second Circuit's holding, *the fact that the option does not totally prevent transfer does not obviate the question as to whether there is any lawful purpose supporting the option at the time of its exercise.* The Second Circuit's failure to determine this issue constituted a radical and unfound departure from the established law of New York.

It is significant that neither in *Biltmore* nor *Penthouse Properties* was the court presented with a contention that the options there in issue were no longer supported by any legitimate corporate purpose. To the contrary, in both those cases the options continued to serve a legitimate corporate purpose, *e. g.*, keeping a close corporation closed.

Sands Point Land Co., Inc. v. *Rossmoore* [43 Misc. 2d 368 (Sup. Ct. 1964)], is the only reported New York case in which the lawful purpose supporting the option no longer existed at the time of its exercise. There, the court refused to permit a corporation to exercise its first option to repurchase, when the directors had already made a decision to dissolve the corporation. The reasoning of the court, which is fully applicable here, is stated as follows:

> "The restrictive stock agreement is a device to assure 'the succession in interest of persons most likely to act harmoniously with the other shareholders'. In the instant case this *rationale* does not apply since there will be no 'succession in interest' inasmuch as the corporation is ceasing to exist. . . ." [Id. at 372]

Here, Thompson's decision to "go public" is fully comparable to the decision in *Sands Point* to dissolve the corporation. In both instances, the corporate decision eliminated the necessity for a "succession in interest" which previously constituted the lawful purpose supporting the existence of the option restriction. Of critical importance in *Sands Point* is the court's analysis of the change in corporate structure and its impact on the validity of the first option.

The decision in *Sands Point,* rendered seven years after *Biltmore,* points out that when determining the validity of an option the courts of New York will not restrict their consideration to the four corners of the option agreement, as the Second Circuit has done in this case. More specifically, under the law of New York, the validity of an option agreement does not rest solely upon the issue of whether that agreement totally prevents transfer but, as *Biltmore, Penthouse* and *Sands Point* make clear, upon whether or not there is any lawful corporate purpose supporting the existence of the option at the time of its exercise. The Second Circuit's summary dismissal of petitioners' contentions below and its per se analysis as to the validity of the Thompson option is an aberration of the settled law of New York.

2. The decision below defeats the congressional intent in enacting Section 10(b) of the Securities Exchange Act of 1934, rejects the SEC's purpose in promulgating Rule 10b-5 and conflicts with prior judicial interpretations given to the Act and Rule.

In affirming the District Court's judgment with respect to Ryan's Rule 10b-5 claim, the Second Circuit held that

whatever Ryan knew or did not know regarding Thompson's plans to "go public" was "irrelevant". Obviously, this conclusion assumes the validity of the Thompson option. As previously demonstrated in this petition, once Thompson made its decision to "go public", its option to purchase Ryan's stock was no longer enforceable. The resulting invalidity of the option mandated that Thompson disclose to Ryan the material information that it had decided to "go public" and in fact had taken concrete steps to implement that decision. Section 10(b) and Rule 10b-5 clearly interdict the non-disclosure of material information and facts in connection with the sale or purchase of any securities.* In connection with Ryan's purchase of Thompson's stock, one can conceive of no more material information than that Thompson had decided, and had in fact taken steps, to "go public" and that as a result thereof the option to repurchase had become void and unenforceable. It is Thompson's failure to disclose this material information which constituted an individual violation of federal law, i.e., Section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5.

The fact is, that as of January 14, 1969, there was a strong probability that Thompson would "go public" and indeed would do so in the very near future. The non-disclosure of the decision to "go public" and the steps taken toward that end undermined and destroyed the equality of bargaining position clearly envisioned by the framers of Section 10(b) and Rule 10b-5.

Thompson alone was in a position to evaluate the probability and expectation of a public offering and the anticipated magnitude of that event. This inequity based upon

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* A material fact is "one to which a reasonable man would attach importance in determining his choice whether to make the sale or not". [*Ross* v. *Licht*, 263 F. Supp. 395, at 408 (S.D.N.Y. 1967), citing with approval *List* v. *Fashion Park, Inc.*, 340 F.2d 457, at 461-63 (2d Cir. 1965), *cert. denied*, 382 U.S. 811 (1966)].

unequal access to critical information goes to the heart of the federal securities laws and petitioners' claim below should not have been mischaracterized by the Second Circuit as "wholly inappropriate and wide of the congressional mark". Moreover, the violation of the federal securities laws complained of herein is one of critical importance in light of the large number of close corporations which are currently going public in quest of working capital.

In an analogous situation, this Court extended the protection of the federal securities laws to employees who had purchased stock in a closely held corporation holding, *inter alia,* that § 4(1) of the Securities Act of 1933 [15 U.S.C. § 77d] was applicable to such sales. The Court noted that "[t]he focus of inquiry should be on the need of the offerees for the protections afforded by registration. The employees here were not shown to have access to the kind of information which registration would disclose. The obvious opportunities for pressure and imposition make it advisable that they be entitled to compliance with § 5". [*S.E.C.* v. *Ralston Purina Co.,* 346 U.S. 119, at 127 (1953)]

It is respectfully submitted that since Ryan's claim arose out of, and is bottomed upon, a public offering of securities made pursuant to the federal securities laws, a federal court is not only the most appropriate forum but, indeed, the only forum in which complete relief can be obtained. The decision of the Second Circuit countenances a grave injustice to Ryan and, in light of the frequency in which close corporations are "going public", may be expected to have a substantial and detrimental effect upon the rights of selling shareholders whose stock is called.*

*The Court is respectfully requested to take judicial notice of the fact that many closed corporations with option agreements similar to the one here in issue, including advertising agencies, stock brokerage firms and insurance agencies, are "going public" with increasing regularity.

Conclusion

For the foregoing reasons, petitioners request that their petition for writ of certiorari be granted.

Respectfully submitted,

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Appendix A

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 67—September Term, 1971

(Argued November 4, 1971 Decided November 18, 1971.)

Docket No. 71-1385

O'NEILL RYAN and UNITED STATES TRUST COMPANY OF NEW YORK, as Trustee of a Trust dated April 15, 1968 for the benefit of Sara Ryan Hill,

Plaintiffs-Appellants,

v.

J. WALTER THOMPSON COMPANY,

Defendant-Appellee.

Before:

WATERMAN, SMITH and TIMBERS,

Circuit Judges.

Appeal from summary judgment entered in the Southern District of New York, Inzer B. Wyatt, *District Judge*, 322 F. Supp. 307 (S.D.N.Y. 1971), in favor of defendant dismissing action brought pursuant to Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5, the complaint also having asserted a state law claim under the doctrine of pendent jurisdiction.

Affirmed.

LEO T. KISSAM, New York, N. Y. (Anthony S. Genovese, Robert A. Warren, Michael F. Fitzgerald and Kissam & Halpin, New York, N. Y., on the brief), for Appellants.

Appendix A

EDWARD J. ROSS, New York, N. Y. (Miriam C. Feigelson and Breed, Abbott & Morgan, New York, N. Y., on the brief), for Appellee.

PER CURIAM:

This case is another example of a trend we have observed with disturbing frequency, namely, invocation of the salutary anti-fraud provisions of the federal securities laws in cases where those provisions are wholly inappropriate and wide of the Congressional mark. Moreover, the vice of this practice is compounded here by engrafting upon the misplaced federal securities law claim a state law claim that, but for the federal gloss, should have been litigated in the state courts.

Appellants, O'Neill Ryan and the United States Trust Company of New York, as Trustee,[1] appeal from a judgment entered in the Southern District of New York, Inzer B. Wyatt, *District Judge*, 322 F.Supp. 307 (S.D.N.Y. 1971), granting a motion by appellee, J. Walter Thompson Company (JWT), for summary judgment and dismissing the action brought by Ryan pursuant to Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (1970), and Rule 10b-5 thereunder, 17 C.F.R. § 240.10b-5 (1971), the complaint also having asserted a state law claim under the doctrine of pendent jurisdiction.[2] Since we agree with the District Court's application of the law to the undisputed facts, we affirm.

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[1] Ryan's transfer in April 1968 to the United States Trust Company of certain JWT stock in trust for his daughter is of no significance here. Ryan and the Trust Company are treated as one for purposes of this appeal.

[2] The judgment of the District Court also dismissed JWT's counterclaim. No appeal has been taken from that part of the judgment.

Appendix A

In view of the District Court's clear, comprehensive and detailed statement of the facts, 322 F.Supp. at 308-312, it is sufficient for our purpose merely to state the claims asserted and the District Court's rulings thereon with which we agree.

The gravamen of Ryan's grievance is that, following his retirement on January 31, 1966 as a vice-president and director of JWT, the latter on January 14, 1969 exercised its option to purchase Ryan's stock in JWT at the net asset value of $276,200 (excluding any value for good will), as compared to the $970,650 value said to be attributed to such stock (including good will value) after JWT's public offering of its stock in June 1969.

Ryan had acquired his stock while employed by JWT. During this period JWT sold its stock only to its officers and employees. All such stock was subject to certain restrictions the purpose of which was to enable JWT to buy back its stock, at net asset value, whenever a holder desired to sell or ceased to be an officer or employee.

Beginning in August 1968, JWT, needing additional working capital, took steps to sell some of its stock to the public through a public offering, removing the restrictive options on such shares. A registration statement and preliminary prospectus were filed with the SEC on March 28, 1969. On June 4, 1969, the public offering of 27% of JWT's shares took place. This resulted in changing JWT from 100% to 73% employee-owned.

Ryan's action in the District Court was brought to rescind his sale of JWT stock in January 1969 pursuant to JWT's exercise of its options. Ryan's essential claims in this action are (1) that, since JWT had taken steps to go pubic when the options were exercised in January 1969, such options were unenforceable as an unreasonable restraint upon alienation under New York law (state law claim); and (2) that JWT's failure to disclose its contemplated public offering prior to its repurchase of Ryan's

stock constituted a violation of the anti-fraud provisions of the Securities Exchange Act of 1934 (federal law claim).

Since there is no basis for diversity jurisdiction, it is clear that there is no federal jurisdiction with respect to the state law claim referred to above unless pursuant to the doctrine of pendent jurisdiction. While the parties on appeal have not addressed themselves to this issue, we have examined the record ourselves. *Gem Corrugated Box Corp.* v. *National Kraft Container Corp.*, 427 F.2d 499, 501 n. 1 (2 Cir. 1970), and cases there cited. We agree with the District Court that it properly could exercise jurisdiction over the state law claim under the doctrine of pendent jurisdiction. And since we have discussed this subject recently, we see no need to dilate upon it here. See *Leather's Best, Inc.* v. *SS. Mormaclynx*, —— F.2d ——, —— - —— (2 Cir. 1971), slip op. 247, 258-62 (October 29, 1971).

With respect to the merits of the state law claim, the District Court, rejecting Ryan's contention that the options when exercised were invalid because their underlying purpose—employee ownership of the stock—was no longer required by JWT corporate policy, held under New York law that, regardless of the corporate policy underlying the option agreement, such agreement would be invalid only if it prevented transfer of the stock, as opposed to merely delaying transfer, as here, by giving the corporation a right of first refusal. We agree. *Allen* v. *Biltmore Tissue Corp.*, 2 N.Y. 2d 534, 161 N.Y.S. 2d 418, 141 N.E. 2d 812 (1957); *Penthouse Properties, Inc.* v. *1158 Fifth Avenue, Inc.*, 256 App. Div. 685, 11 N.Y.S. 2d 417 (1st Dept. 1939). See also *Rafe* v. *Hi[illegible]* App. Div. 2d 481, 288 N.Y.S. 2d 662 (2d Dept. 1[illegible] *aff'd*, 23 N.Y. 2d 759, 296 N.Y.S. 2d 955, 244 N.E. 2d 4[illegible] (1968); *Martin* v. *Graybar Electric Co.*, 285 F.2d 619 (7 Cir. 1961).

With respect to the Rule 10b-5 claim, the District Court held that, since Ryan was obligated to sell his shares to

JWT in January 1969, whatever he knew or did not know regarding JWT's plans to go public was irrelevant. We agree. See *Fershtman* v. *Schectman*, —— F.2d ——, —— (2 Cir. 1971), slip op. 325, 330 (November 3, 1971). Ryan's reliance upon *SEC* v. *Texas Gulf Sulphur Co.*, 401 F.2d 833 (2 Cir. 1968) (*en banc, cert. denied*, 394 U.S. 976 (1969), is misplaced. Even under the broadest interpretation of the language of *Texas Gulf Sulphur*, Rule 10b-5 does not spread a comfortable canopy to keep Ryan out of the inclement weather.

In short, we affirm upon the well reasoned opinion of Judge Wyatt below. 322 F. Supp. 307 (S.D.N.Y. 1971).

Affirmed.